

Statement of Raymond C. Scheppach

before the

Senate Budget Committee

on

The State Fiscal Situation

on behalf of

The National Governors Association

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Chairman Conrad, and members of the committee, on behalf of the nation's governors, thank you for the opportunity to appear before you today to discuss the states' fiscal situation.

For 30 years, from 1978-2008, states witnessed average revenue growth of 6.5 percent per year. In fact, only in 1983, were revenues negative – at less than 1 percent. The "Great Recession," which began in December 2008 and was officially declared over in June 2009, was a huge game changer for state governments. Between the last quarter of 2008 and the last quarter of 2009, revenues decreased five consecutive quarters, by 4.0 percent, 12.2 percent, 16.8 percent, 11.5 percent, and 4.0 percent respectively. While revenues for all states have now grown for three consecutive quarters, it has only been by 3 percent on average and would have been flat if it had not been for major tax increases in California and New York. Preliminary early reporting estimates from 41 states did, however, show an increase of 6.9 percent for the last quarter of 2010. In spite of these recent increases, total state revenues are still down about 9 percent in 2010 relative to 2008.¹

In response to these revenue declines, states cut spending by \$75 billion and enacted fee and tax increases of \$33 billion over state fiscal years 2008-2010. The cuts would have been much more draconian if the American Recovery and Reinvestment Act and its extensions had not been enacted. Here, the federal government provided states \$103 billion in flexible Medicaid funds and \$48 billion in education funds. They provided another \$10 billion in education funds that passed through states to local school districts. Even with this federal assistance, states are still

¹ The Nelson A. Rockefeller Institute of Government.

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looking at shortfalls of about \$175 billion over the 2011-2013 period, with a definite cliff the end of state fiscal year 2011, i.e., July 1, 2011, when the enhanced Medicaid funds end.

The Rest of the Decade

Unfortunately, the "Great Recession" was so deep and so broad that it will continue to have impacts on state government throughout this decade in the following three stages.

- The first stage is state fiscal years 2010, 2011 and 2012. Previous economic downturns have shown that the biggest impact on states is the first, second and, at times, the third year after the recession ends. This is because the major decline in revenues and the explosion in the Medicaid rolls come very late in the economic cycle.
- The second stage is the "jobless recovery," which will prevent most states from returning to their 2008 revenue levels until 2013 or 2014 and, in some cases, 2015. This means zero revenue growth over five to six years compared to the previous long-term average of 6.5 percent per year a huge reduction.
- In the third stage, beyond 2015, states will have to meet many of the needs that were deferred over the preceding six years. While there are many unmet needs—including maintenance on structures, rebuilding "rainy day" funds and upgrading management information systems—the largest need is the retiree pension trust funds that now have significant unfunded liabilities. This is also the period when states should witness a rebound in state revenues, but the revenue path going forward is likely to be lower than the 6.5 percent experienced over the last 30 years. Finally, it is when states will see accelerated Medicaid growth.

The Structural Deficit

States have struggled with structural long-run deficits for some time because of their obsolete tax systems and the double digit growth of Medicaid, which is now 22 percent of state budgets.

However, they were able to make yearly adjustments to spending and revenues to maintain balanced budgets. After the "Great Recession," this structural deficit has become significantly larger and is caused by: 1) a revenue path going forward that will likely grow more slowly than that over the last 30 years; 2) retiree pension and health care unfunded liabilities that have ballooned over the last several years; and 3) state Medicaid spending that will grow rapidly over the next 10 years.

State Revenues – Even if state revenues recover from the "Great Recession" later in this decade, the long-run outlook is likely a lower revenue growth than the 6.5 percent experienced over the last several decades. First, it is doubtful that the U.S. economy will grow as rapidly over the next decade as it has over the previous three decades. This is because of a combination of factors including higher interest rates associated with the huge federal debt, more regulation, higher taxes by all levels of government, diminishing workforce quality relative to U.S. trading partners and more international sovereign debt and currency volatility. Second, states have tax systems that were built for a manufacturing economy of the 1950s, not a high technology, serviceoriented, international economy of the 21st century. For example the sales tax, which represents about 40 percent of state revenues generally, only applies to goods, not services, and not to many goods sold over the Internet or downloaded from the Internet. Alternatively stated, new economy outputs are growing but avoiding taxation; old economy goods are not growing yet bearing the tax burden. This low elasticity for the sales tax is a major problem as new economy outputs increasingly erode the tax base. States can fix this problem by reforming taxes, but reform is politically difficult.

Medicaid – Medicaid costs to states in 2008 were about \$152 billion or 22 percent of state budgets. Enrollment has increased by 6 million since the recession began and total Medicaid spending growth averaged 8.8 percent in fiscal year 2010 with enrollment growth of 8.5 percent - the highest rates of growth in eight years. States anticipate a spending increase of 7.4 percent in 2011; however, this may be low because state estimates have been low for the last couple of years. According to the 2010 Actuarial Report on the Financial Outlook for Medicaid by the Office of the Actuary of the United States Department of Health and Human Services, the Patient Protection and Affordable Care Act (ACA) is projected to add 11.6 million people to the enrollment in 2014 and almost 20 million by fiscal year 2019. The actuarial report has state spending growing from \$133.5 billion in 2010 (which is low because of the enhanced federal match from the Recovery Act) to \$224.1 billion in 2014, which is the first year of the Medicaid expansion. This means that the combination of the higher case load growth due to the "Great Recession," the 2012 state fiscal year cliff when the enhanced federal match ends, and the ACA will require states to pay an additional \$90 billion between 2010 and 2014. If the actuarial report is correct, states will pay another \$100 billion over the five-year period of 2014 to 2019.

Medicaid's growth rate can be brought down in several ways. First, if many of the cost control provisions in the ACA work well. Second, if governors and states work with stakeholders in their states to create more transparency regarding price and quality of all health care in a state and they bring about changes in the current fee-for-service system. Third, if the federal government provides states with more flexibility in administering the program.

Pension Problem – Unfunded liabilities have grown substantially because of both the lower rate of return on investments and the fact that many states did not contribute to the retiree pension and health care trust funds over the last few years. In 2000, state and local pension obligations were essentially fully funded with an assumption of an 8 percent discount rate. By 2009, the unfunded liability was about 15 percent. By 2010, the total unfunded liability for state and local governments had increased to 23 percent of obligations. While this is a significant change, it must be remembered that current employer contributions are only about 3.8 percent of state budgets. If this was increased to 5.0 percent, states could eliminate their unfunded liabilities in pension funds over time.

This level of unfunded pension liabilities is a problem, but states are now making changes to reduce the liability. Between 2005 and 2010, 30 states made pension changes. In 2010, pension actions accelerated with at least 20 states making further changes. Actions states are taking focus on raising length of service requirements, extending the retirement age, increasing employee contribution rates and lowering cost-of-living adjustments (COLAs). Illinois and Missouri, for example, raised the retirement age to 67, and Massachusetts is calling for the same in 2011. Additionally, 11 states made benefit and contribution changes during 2010. For example, Colorado increased the employee contribution rates for fiscal year 2011 by 2.5 percentage points. The contribution changes affect active employees and new employees in seven states, while four states made changes affecting future hires only. Seven states made changes to COLAs. For example, South Dakota removed COLAs for retirees in the first year of retirement, while Rhode Island and Virginia reduced COLA increases for new hires. Other states made significant

changes to their defined benefit systems. Michigan and Utah moved from defined benefit plans to hybrid plans during 2010. Utah has closed its defined benefit plan to new workers entirely.

Short-run State Action

Given the fact that states are still looking at shortfalls of \$174 billion over the next several years, governors and state legislators understand that they have to continue to downsize and consolidate state government. In fact, it is not enough to just cut budgets, consolidate agencies, and reduce the number of state employees. They also have to redesign the delivery system of all major functions of state government, from prisons to elementary and secondary education to higher education, to make state government more efficient and sustainable over the long run.

While this will be difficult, I think that states will be able to work through these challenges over the next couple of years without any major crisis. States do have larger unfunded pension liabilities, but they have accelerated actions over the last two years and I am optimistic that they will be able to put solutions in place.

This Fiscal Year

Despite states' difficult fiscal conditions, governors are not calling for new one-time help from the federal treasury. In fact, they encouraged the federal government to follow the lead of states and make tough decisions necessary to get its fiscal house in order; federal fiscal stability is critical to the long-term strength of states and the country.

As federal lawmakers work to reduce deficits, reform programs and restore long-term stability, governors call on the Administration and Congress to adhere to the following principles for state-federal deficit reduction:

- Federal reforms should be designed to produce savings for both the federal government and states. The shared responsibility for implementing and running state-federal programs should also mean shared savings when reductions or reforms are made at the federal level.
- Deficit reduction should not be accomplished by merely shifting costs to states or imposing unfunded mandates. The structural deficit facing federal lawmakers cannot be solved by the states. Good fiscal policy must take into account the effects of federal action on state government to avoid actions that harm the ability of governors to manage state budgets.
- States should be given increased flexibility to create efficiencies and achieve results.

 Decreases in funding should be accompanied by an increase in state authority to manage programs and find savings. For example, states must be allowed to consolidate funds from similar programs to provide better results. Federal mandates, even those that are paid for, fail to encourage state innovation or cost savings that can benefit both states and the federal government.

• Congress should not impose maintenance of effort (MOE) provisions on states as a condition of funding. MOE's curtail state authority to control their own budgets and fiscal systems and, over time, discourage investment in state-federal programs.

It is also important to indicate that states are opposed to Congress enacting any legislation that authorizes bankruptcy for states. No governor or state is requesting this authority and it is also true that such authority will likely increase interest rates, raise the cost of state government and create more volatility in financial markets. Governors are strongly opposed to such legislation.

Longer Run

It is up to states to fix their revenue and pension problems. After the next couple of years, however, the projected growth in Medicaid will continue to be a serious funding problem for states as there are three factors coming together during the 2010-2014 period that will accelerate the growth in state Medicaid spending. First, the Medicaid caseload has grown rapidly over the last two years because of the weakness in the economy. Second, states will lose the additional federal aid on July 1, 2011. And third, the ACA will expand the Medicaid program. The federal government will need to work with states to change the Medicaid program to slow its expenditure growth for both levels of government and create a more efficient program, with a more equitable sharing of the costs between the federal government and states consistent with federalism.

Conclusion

Mr. Chairman, there are several conclusions we can reach regarding the state fiscal situation.

First, states have already cut \$75 billion in spending and raised taxes by \$33 billion over the

last two years. Governors understand that they have more to do to make state programs

sustainable over the long-run. They will be able to close the \$175 billion in shortfalls over

the next few years unless the economy slows considerably. Therefore, I see no crisis for

states regarding pensions or other issues over the next couple of years. Second, governors are

not requesting additional one-time fiscal relief, but would like more flexibility on programs

and relief from maintenance of effort provisions. Third, after a few years the projected

growth in Medicaid will be difficult for states to fund.

Congress needs to focus on this issue and work with governors to change the Medicaid

program to slow the growth in spending for both state and federal government, create a more

efficient system and create a more equitable sharing of the costs between the federal

government and states consistent with federalism.

Mr. Chairman, I would be happy to answer any questions. Thank you.